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E.O. 12958: N/A
TAGS: ECON EINV ELAB ETRD EFIN CH
SUBJECT: Leaving the PRD - Regulations and Market Conditions Forcing Some Factories Out

Ref: A) 07 GUANGZHOU 1180, B) GUANGZHOU 121

¶1. (SBU) Summary: The numbers differ dramatically, with some investors hyping a massive exodus of factories from the Pearl River Delta (PRD) while local government officials spout figures that obscure the scale of the trend. But one thing is clear: many firms are choosing to move production to new centers of low-wage manufacturing in other parts of China and elsewhere. Executives frequently cite China's new Labor Contract Law as the driving force behind relocations, but it only one in a list of factors that have weakened the investment environment here and may not even be the most important one. (In fact, U.S. companies say they are already compliant with contract law requirements and the new rules will compel competitors to come up to these standards.) Others include wages that were already raising steadily, value-added tax and export processing regulatory changes, and the appreciation of the renminbi against the dollar. Even as labor-intensive, often Hong Kong- or Taiwan-invested, factories move, many others are choosing to stay for reasons that include robust supply chains, well-developed infrastructure and human capital, which continue to be enduring advantages of the PRD. The composition of economic development in the Delta is changing and the difficult choices facing business today are in large part intentional: the central and local governments are implementing policies aimed both at spreading development to other, less-developed parts of China and at creating space to upgrade industries in the PRD. If the strategy succeeds, the PRD could once again be in the fore as China moves into a new stage of economic development. No one wants to contemplate what failure to change will mean. End summary.

Looking at the Numbers - Media Hype,...

¶2. (U) Reports of factories leaving the Pearl River Delta (PRD) have been spreading in recent months. A Wall Street Journal article cited estimates by the Federation of Hong Kong Industries that 10 percent of Hong Kong-owned factories in the region will close this year. Another frequently cited statistic is the Asian Footwear Association's calculation that 1,000 shoe factories in Guangdong have closed in the past year out of a total of 5,000 to 6,000. A China Daily report cited an estimate that 5,000 to 6,000 Hong Kong-invested companies would close in the PRD by the end of 2008. One American business leader told us that 1,000 factories had closed down in Dongguan alone. A Taiwan investor in Dongguan put the number at 5,000 (ref A).

Official Propaganda,...

¶3. (U) Local officials have tried to downplay the reports. In early

March, Guangdong Governor Huang Huahua told reporters that, according to government statistics, only 244 enterprises had moved out of the PRD while more than 7,000 new enterprises were established during the year. Dongguan Party Secretary Liu Zhigeng recently said that although 289 shoe factories had shut down in Dongguan during 2007, 501 new ones had opened. More recently, Guangzhou Bureau of Foreign Trade and Economic Cooperation announced that 347 foreign-invested enterprises closed or moved out of Guangzhou in 2007 while 959 new foreign enterprises invested in the city. However, local statistics may not capture the closure of some facilities, which the statisticians classify as having "concluded their contracts." These firms may have signed contracts with local partners and obtained business licenses that have expired but will not be renewed, because the foreign investor is no longer interested in doing business here. They might not appear in the government's accounting even though they have ceased production in the PRD.

Business Optimism,...

¶4. (SBU) Many companies in the PRD, especially the larger, more successful ones we have more frequent contact with, have indicated that they continue to believe the investment environment here is strong. Some of them, like Hong Kong-invested toymaker Silverlit, have told us they would stay put in the PRD even as their less profitable competitors moved elsewhere (ref B). Executives at American toy makers Mattel and Hasbro have emphasized to us that their long-term investments in China were profitable decisions, and to relocate production outside of the PRD would be a step in the wrong direction. A former Dongguan Taiwan Businessmen's Association vice chair said the PRD was still the best place for him to do business while lamenting the problems other Taiwan firms faced (ref A). During a recent visit to Zhuhai and Zhongshan on the western side of the PRD, executives at Flextronics, a Singapore-based

electronics manufacturer; Wiseman Company, a major Chinese garment maker; and Foxconn, the Taiwan electronics giant, all described to us ambitious plans to expand operations.

...and Hidden Impact

¶5. (SBU) However, there is also downsizing among some firms staying in the PRD that is not captured in official statistics or other reports. An executive in the Dongguan Taiwan Businessmen's Association explained that many Taiwan companies are maintaining some manufacturing presence in the PRD to hedge their bets even as they build new facilities or expand operations elsewhere. He identified one factory in the Humen area of Dongguan that had downsized from 5,000 to 2,000 employees recently. Despite expansion in its facility just across the river, Foxconn's massive campus in Shenzhen continues to reduce employment as it moves manufacturing operations elsewhere to focus more on research and development and other high-end processes in the PRD (ref B).

What's Driving Them Away?

¶6. (SBU) There are several factors that are causing many factories to consider moving production out of the PRD:

--Labor Contract Law - Many firms and industry associations have complained loudly about the new law, which went into effect on January 1. Estimates vary, but the Hong Kong SAR government representative in Guangdong recently said the law had increased labor costs by 15 percent. In addition, the law limits the flexibility employers had previously exercised in hiring, and especially firing, decisions. Although this law is one of the causes most often cited in reports about factories leaving the PRD, it is only one of several having an impact and raising production costs here. With many factories moving to other locations in China, it may not even be the most important factor. Investors may complain more about the effects of the Labor Contract Law because they calculate it to be the area where the Chinese government is most likely to offer some redress.

--Rising Wages - Wages were already rising steadily in the PRD before the new Labor Contract Law and continue to do so. Hewitt Associate's annual survey of wages in Guangzhou and Shenzhen showed 8-9 percent increases in 2007 and projected similar increases for ¶2008.

--VAT/Export Processing Reforms - In 2007 the Chinese government reduced the value-added tax rebates available to exporters in some industries and locations and started requiring some export processing firms to pay a guarantee deposit for duties on imported inputs that are refunded at the time of re-export.

--RMB Appreciation - Ongoing appreciation of the renminbi against the dollar has squeezed profits for firms making exports for the U.S. market. The Hong Kong SAR representative estimated that RMB appreciation was increasing the cost of Hong Kong businesses in the PRD by an additional 15 percent.

--Other Factors - In addition, firms in the PRD have been hit with continuing power shortages, rising costs of other inputs and reported stronger enforcement of environmental regulations.

Who's Moving Out? Who's Staying Put?

¶7. (U) These factors are hitting some types of businesses much harder than others. The labor-intensive, export-oriented industries that were the main drivers of the PRD's economic boom from the beginning are most affected. Many of these are Hong Kong and Taiwan enterprises, but some sources have also reported Japanese and Korean firms choosing to the leave the PRD too. (In fact, the Korean Consul General told the Consul General earlier this month that whether and/or when and/or where to move were subjects Korean companies were constantly discussing with him.) "Export processing" industries, which assemble imported inputs into finished exports, have been disproportionately harmed by recent regulatory and market trends. Shoe manufacturers appear to be among those that have suffered the most impact. Many apparel, toy, and hardware manufacturers have also been seriously affected, according to Guangdong's Department of Foreign Trade and Economic Cooperation.

¶8. (U) High-tech manufacturers that rely on more highly skilled labor are less affected. The same is true for firms that invest

heavily in design or marketing their own brand name. In general, American firms appear relatively unaffected because they are more likely to fall into these categories. They are generally more focused on selling to the Chinese domestic market than other foreign investors, who dedicate more production to exports. In addition, several contacts have commented that U.S. firms have actually benefited from the new Labor Contract Law because their practices were already compliant with the new rules, and now their competitors must raise their standards as well.

Staying in the Neighborhood

¶9. (U) For those firms that are choosing to leave the PRD, anecdotal reports suggest their preferred destinations are not that far away. According to one toy manufacturer, many Taiwan firms in the industry have moved to Jiangxi Province. Other reports identify Guangxi, Hunan, Fujian, Anhui and some more remote parts of Guangdong as favored destinations. Vietnam is the most frequently cited option for companies that are looking to leave China altogether. Some investors have commented to us that tax policies and other investment conditions in Vietnam are similar to those of the PRD ten to twenty years ago. However, other investors have dismissed it and other Southeast Asian countries as a suitable alternative, citing smaller workforces and local markets, lack of infrastructure, cultural differences and other disadvantages.

Why Stick Around?

¶10. (SBU) Those companies that choosing to stay in the PRD named the following factors as enduring advantages:

--Supply chains - Many industries have developed sophisticated industrial clusters with complete supply chains providing all inputs in one convenient location. In fact, Toyota established a new Guangzhou factory in 2005 and is already engaged in an expansion project that will increase capacity by almost one third. Executives emphasized the emergence of robust supply chains as one of the most important factors in the company's decision to expand here.

--Infrastructure - The PRD has a well-developed transportation system. One investor told us he had looked at moving his factory to Jiangxi, but calculated that what he gained in lower wages would be lost -- and then some -- due to higher transportation costs.

--Human capital - The availability of skilled labor is much higher in the PRD than many cheaper alternative destinations. An executive at one apparel firm explained to us that she wouldn't be able to convince the designers she relies on to live in more remote areas.

--Diminishing advantages in alternative locations - Several manufacturers have told us their research shows that the gap in wages and tax benefits enjoyed in less-developed parts of China will diminish within a couple of years relocating to these areas. Executives from one Hong Kong apparel company said that they opened a second factory in Jiangxi three years ago when wages were just 60 percent of those in the PRD, but wages had been rising more quickly than in the PRD and tax incentives had gradually phased out.

All Part of the Plan

¶11. (SBU) These complex sets of factors are having a real, but difficult to quantify, impact on factories in the PRD. Some of this impact is intentional -- central and local government officials want to create conditions that will encourage some factories, especially labor-intensive ones, to move out of the PRD. Changes in the VAT rebate and export processing regulations target these industries directly as do some environmental regulatory changes. These policies are aimed both at spreading development to other, less-developed parts of China and at creating space to upgrade industries in the PRD toward services and more advanced technologies. If the strategy succeeds, the Pearl River Delta area could once again be in the fore as China moves into a new stage of economic development. In the meantime, there will be a difficult adjustment period as the exodus of labor-intensive, export-oriented factories, which have been the backbone of the local economy for many years, continues.

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